Internal Revenue Service

memorandum

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Br2:DCFegan

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to: District Counsel, Chicago CC:CHI
Attention: James Stanis

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted] v. Commissioner
T.C. Dkt. No. [redacted]

This is in reply to your request for tax litigation advice on two issues involved in the above-captioned case.

The case concerns a nonexempt cooperative which files a consolidated income tax return with its [redacted] wholly owned subsidiary corporations. The case is set for trial at the trial session commencing in [redacted] on [redacted].

ISSUES

(1) Whether, in computing taxable income, nonpatronage sourced income of one member of a consolidated group may be offset by patronage sourced losses of another member of the group.

(2) Whether patronage dividends may be computed based on book income rather than taxable income.

CONCLUSIONS

(1) The nonpatronage sourced income of one nonexempt cooperative in a consolidated group may not be reduced by the patronage sourced income of another member of that group.

(2) Patronage dividends must be computed on the basis of taxable income rather than book income.

DISCUSSION

Issue (1): The Netting Issue

On its [redacted] consolidated income tax return, [redacted] reported earnings of $[redacted] of which $[redacted] was

deducted as a patronage dividend. The remaining $[redacted] of taxable income was all from nonpatronage sources.1/

Two subsidiary corporations reported patronage-sourced losses. [redacted] had net income of $[redacted], but reported a $[redacted] loss after payment of a $[redacted] patronage dividend. [redacted] reported a loss of $[redacted] from patronage sources and deducted no patronage dividends. The petitioner netted these patronage sourced losses of [redacted] and [redacted] against the nonpatronage sourced income of [redacted] to derive the consolidated taxable income.

You are aware that Service position is that nonpatronage-sourced income may not be netted against patronage-sourced losses. You are also aware that Service position was upheld in Farm Service Cooperative v. Commissioner, 619 F.2d 718 (8th Cir. 1980), rev'g 70 T.C. 145 (1978); and Certified Grocers of California, Ltd., and Subsidiaries v. Commissioner, 88 T.C. 238 (1987). However, the petitioner claims that these cases do not prohibit netting where the nonpatronage-sourced income is netted against a true economic patronage-sourced loss not caused by payment of a patronage dividend. Citing footnote 21 in Certified Grocers, the petitioner argues the policy of assuring patronage dividends are paid only from patronage-sourced income is maintained where the loss is a true economic loss. Thus, the petitioner claims courts would be willing to break down the "two pot" theory of cooperative income and allow netting where the patronage sourced loss is an economic one.

In your settlement discussions you have taken the position that the government faces no viable hazards on this issue. The petitioner admits the weight of authority favors the Service's position, but contends hazards exist. You wish to know whether we see a reason to differentiate between patronage losses that are economic in nature and those caused by payment of a patronage dividend, and you wish to know our assessment of the hazards on this issue.

Our assessment of this issue is consistent with yours in that we give little credence to petitioner's argument and place the Government's prospects of prevailing in the 90- to 95-percent range. Suffice it to say the Farm Service Cooperative and Certified Grocers of California cases are directly on point in that they disallow the netting of nonpatronage income and patronage losses. Moreover, the issue in the latter case arises in the context of a consolidated group as in the instant case. Like the instant case, Certified Grocers also arose in the Tax Court.

1/ These figures contain a $[redacted] discrepancy of unknown origin.

Not only is there good authority directly on point in the same court, but also we do not understand the basis for distinguishing economic losses from those triggered by patronage dividends. Footnote 21 in Certified Grocers makes no such distinction and we are aware of none suggested in any case. On the other hand, we do understand the basis for disallowing netting between patronage and nonpatronage activities. The basis is the concept of patronage activities as business conducted "with or for" patrons. I.R.C. § 1388(a). That is, the cooperative is conducting patronage activities on behalf of its patrons with the gains (or losses) accruing to them. If the cooperative were required to distribute its gains from patronage activities to patrons, but could offset patronage activity losses by nonpatronage activity gains, such activities could hardly be said to be "with or for" patrons. Your "two pot" characterization is apropos with the net gain (or loss) in one pot accruing to patrons.

Of course, we are not suggesting that losses accruing in one year are an obligation of the patrons doing business with the cooperative in that year. Rather, we are suggesting that such losses remain in the patronage pot and be carried to other years. Cf., Rev. Rul. 74-377, 1974-2 C.B. 274.

Issue (2): Patronage Deduction Based on Book Income

In [redacted] and [redacted], some of petitioner's subsidiaries computed their patronage dividends based on book income rather than taxable income. This resulted in a larger patronage dividend deduction than would have resulted using taxable income. The revenue agent disallowed this treatment and recomputed the patronage dividend deduction based on taxable income, citing Rev. Rul. 74-274, 1974-1 C.B. 247.

As you point out, this revenue ruling appears to be the only authority supporting this position. However, the Tax Court in Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729, at footnote 8, expressed its doubts as to the correctness of this ruling (without explaining the basis for those doubts). Moreover, in Certified Grocers of California, Ltd. and Subsidiaries v. Commissioner, 88 T.C. 238 (1987), the Commissioner stipulated that the cooperative had a loss caused by the payment of a patronage dividend based on book income rather than taxable income. Footnote 8 of that opinion explains that taxable income was lower than book income because (1) tax-exempt interest was includable only in book income, and (2) larger deductions were claimed for tax purposes than for book purposes. You believe these cases cast some doubt on the validity of the position expressed in Rev. Rul. 74-274 and wish to know our views.

We agree with you on this issue as well. We are doubtful the courts will require nonexempt cooperatives to base their patronage dividends on taxable income in all instances.

We obtained the file on Rev. Rul. 74-274 in an effort to understand the rationale for the taxable income requirement contained therein. Below is an excerpt from the underlying private letter ruling that formed the basis for the published ruling:

> The phrase, "net earnings of the organization from business done with or for its patrons," in section 1388(a) has reference to that part of the cooperative's income which would otherwise be treated as the taxable income of the cooperative if it were not distributed to its patrons. Congress, recognizing the distinctive characteristics of the cooperative form of doing business, has attempted to tax currently the income of the cooperatives either to the cooperatives or to the patrons. In enacting the Revenue Act of 1951, 65 Stat. 452, which for the first time taxed cooperatives that had heretofore enjoyed complete exemption, Congress attempted to impose such a single tax. Senate Report No. 781, C.B 1951-2, 458 at 473, states:
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> "As a result of this action, all earnings or net margins of cooperatives will be taxable either to the cooperative, [or] its patrons ....
>
> "While the tax treatment provided by your committee for cooperatives does not impose the double tax payable in the case of ordinary corporate income, your committee believes that the securing of a single tax with respect to substantially all of the income of cooperatives should be sufficient in view of the unique characteristics of a cooperative."
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> In the Revenue Act of 1962, 76 Stat. 1045, Congress, in light of several court decisions, once again revised the tax treatment of cooperatives although still

maintaining the single tax concept. Senate Report No. 1881, C.B. 1962-3,, 707 at 822, states:

"Generally, the effect of the treatment specified above for patrons taken together with that also outlined above for cooperatives is to obtain a single current tax with respect to the income of the cooperative, either at the level of the cooperative or at the level of the patron."

From these committee reports, it is obvious that Congress intended that the income of the cooperative derived from business done with or for its patrons during the taxable year be taxed at the cooperative level if it were not distributed to its patrons in the form of a patronage dividend. Therefore, it follows that only the income of the cooperative derived from business done with or for its patrons is available for distributions as a patronage dividend and that the term "net earnings" has reference only to that income. To look to other than the income of the cooperative as reported on its tax return in determining the amount available for distribution as a patronage dividend, as for example, "book" net earnings, would do violence to Congress's single tax concept as it would bring into consideration an amount which does not enter into the computation of the cooperative's taxable income.

It should be noted that prior to the Revenue Act of 1962, there was no comprehensive definition, as found in section 1388(a) of the Code, of a patronage dividend. However, regulations section 1.522-1(b)(4)(ii), now obsolete, defined the term "earnings" as including "the excess of amounts retained (or assessed) by the association to cover expenses or other items over the amount of such expenses or other items." In light of the statements in Senate Report No. 781, cited previously, it seems that Congress in using the term "earnings" meant the taxable income of the cooperative

from business done with or for its patrons. (See Growers Credit Corporation, 33 T.C. 981 at 994 (1969).)

In the instant case, a distribution by the cooperative of an amount greater than the taxable income of the cooperative from business done with or for its members will not qualify as a patronage dividend to the extent that it is in excess of such taxable income.

Frankly, we find this rationale to be somewhat tenuous and the revenue ruling to be somewhat arbitrary. We suspect the courts will allow whatever is fair in the situation before it.

We doubt the courts would allow taxpayers to commit abuse by switching between patronage dividends based on taxable income and book income depending upon which was more advantageous. However, we suspect the courts would allow patronage dividends based on either income if consistently applied. This is not to say that tax exempt patronage income would be both tax exempt to the cooperative and deductible by the cooperative if distributed to patrons, rather only that there would be no tax to the cooperative with respect to that income. Likewise, where book income exceeded taxable income because of accelerated depreciation used to compute the latter, we believe the courts more likely than not would allow a patronage dividend deduction up to the amount of the book income.

In defending Service position on this issue, we would stress that in a tax context "income" generally means taxable income; whereas, book income is an accounting concept. To the extent a cooperative lowers its taxable income by use of accelerated depreciation methods, that is its choice. Without knowing more about the facts of the instant case, we cannot comment further on the litigating prospects regarding this issue.

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